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# Intelligence Report

*Office of Asian Pacific and Latin American Analysis* *26 January 1999*

## China's Quest for Oil Security [redacted]


### Summary

***In response to growing long-term domestic demand and stagnating domestic oil production, China is pursuing an energy security policy that calls for establishing enduring diplomatic and business relationships with oil-producing countries in five geographic regions: the Middle East, Central Asia, Latin America, Russia, and Africa, according to official Chinese press reports.***

- ***Oil is likely to remain a small share of China's total primary energy consumption, but Beijing's evident concern is that supplies are sufficient to meet the needs of the growing transportation and petrochemical sectors, such as fertilizers and plastics.***

- ***Beijing has actively promoted the efforts of Chinese oil companies to reach long-term oil-production sharing arrangements in the development and rehabilitation of foreign oilfields. Although Premier Zhu Rongji appears to be encouraging a more measured approach in overseas oilfield investment than his predecessor, Li Peng, the combination of flat domestic production and rising consumption will necessitate China's continued search for guaranteed supplies of foreign oil.*** [redacted]

[redacted] ***In the short term, China's diplomatic efforts in support of bids to develop foreign oilfields could place US firms at a disadvantage and increasingly challenge US policy in regions in turmoil, such as the Middle East. Over the longer term, Chinese efforts to secure foreign oil resources—for example, by boosting exports to finance oil-related investments or improving power-projection capabilities to protect sea lanes—could create bilateral tensions.*** [redacted]


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**Beijing Searches Abroad for Oil** [redacted]

In a dramatic shift from Beijing's longstanding policy of self-reliance, Chinese oil firms in the past two years have engaged in an aggressive campaign to buy into foreign oil fields, according to official Chinese press reports. The China National Petroleum Corporation (CNPC), China's main oil producer, has struck several high-profile deals by outbidding US companies to win the rights to develop the Aktyubinsk and Uzen oil fields in Kazakhstan and two offshore oilfields in Venezuela, according to various press [redacted] reports. CNPC has also agreed to rehabilitate the Ahdab oil field in Iraq, according to press reports, and various Chinese oil corporations have won oil-related contracts to develop oil fields throughout Asia, the Middle East, Africa, and Latin America (see appendix for details). [redacted]

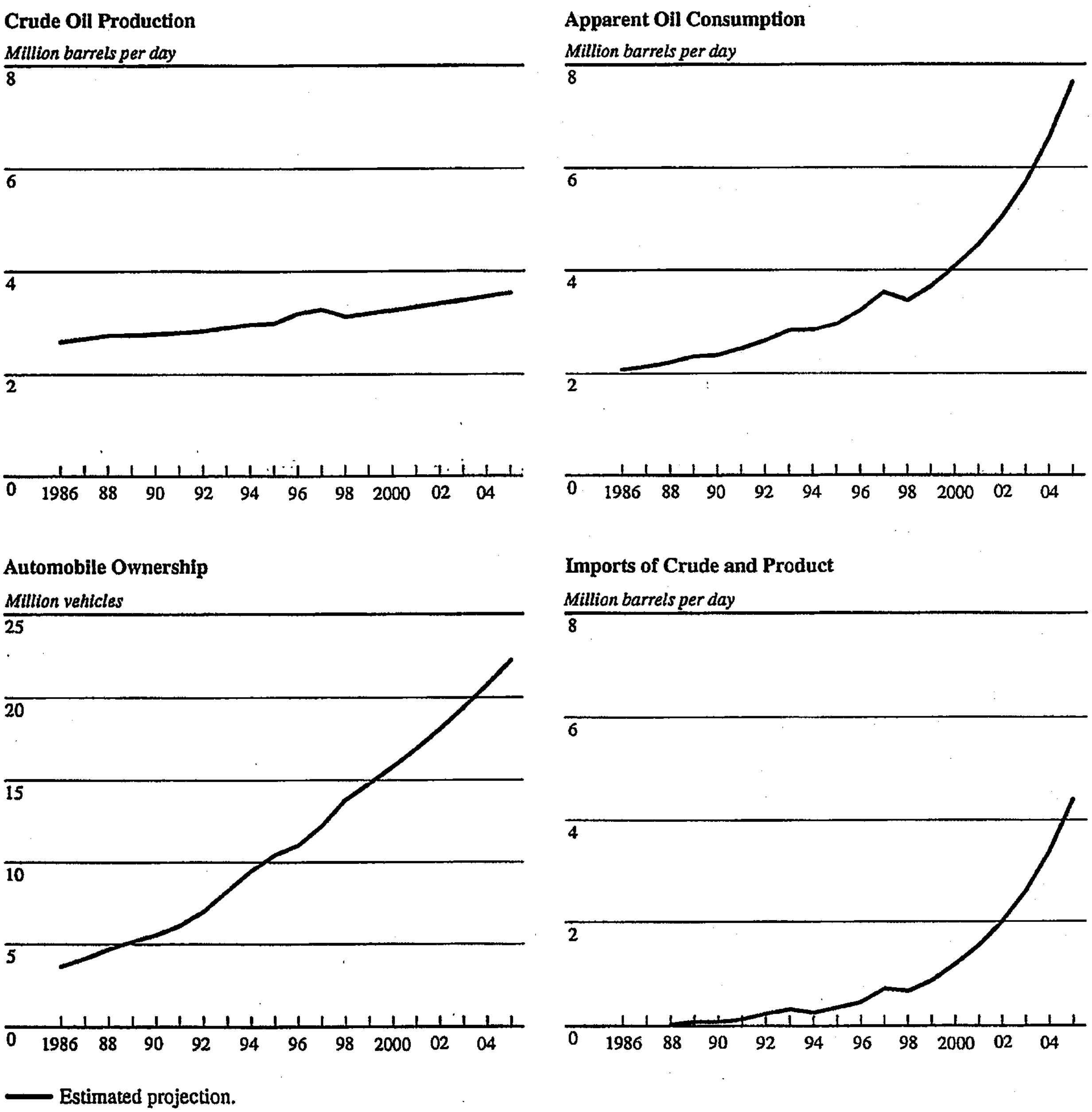
While still looking outward, China's oil industry has been consolidating its overseas commitments since mid-1998 and moving less aggressively than it did in 1997. Last March, Zhu Rongji replaced Li Peng as premier and ushered in a subtle shift in policy; Zhu is apparently less willing than his predecessor to lavish subsidies on state-owned oil companies for their overseas ventures. This is probably due to falling world oil prices that have reduced the value of overseas investments made by the oil companies and flat domestic demand. Chinese oil companies' operating revenues were also hurt when Beijing allowed domestic prices to fall in line with international prices, further weakening their resolve to pursue expensive overseas projects. Consequently, CNPC in October 1998 abandoned plans to buy into the Halfaya oilfield in Iraq and has delayed fulfilling its financial commitments for its investments in Kazakhstan, [redacted]

Despite these short-term adjustments, flat domestic oil production and a rapidly growing economy will force China to continue to look abroad for oil security. The author of this policy, Li Peng, laid out the long-term strategy in a 1997 economic journal article identifying rising domestic oil consumption as the main impetus to Beijing's pursuit of foreign oil. From the late 1980s to 1997, oil consumption grew by 7 percent a year, and, although apparent consumption[1] slowed in 1998 to 2 percent, it is expected to pick up once the economy recovers from the recent slowdown. Most of

[1] Apparent consumption is a rough approximation of actual consumption, derived by subtracting petroleum exports from consumption and imports, without factoring in stocks.

[redacted]

## China's Shifting Oil Needs

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China's oil is used for transportation and petrochemical feedstocks—such as fertilizers and plastics—and anticipated growth in private vehicle use is likely to cause consumption to rise even higher:

- By October 1998, China had over 14 million motor vehicles on the road and Beijing plans to have more than 16 million by 2000, according to official Chinese press reports.

- Additional official press reports indicate that Beijing is facilitating private vehicle usage by making automobile manufacturing a pillar industry, investing in new roads and highways, and directing state banks to offer attractive financing packages.

Not officially stated in Li's article, but evident from other sources, are the problems arising from stagnating domestic oil production:

- China's oil consumption rose over 10 percent in 1997, outstripping domestic production increases of only 2.3 percent and generating a 57-percent rise in crude oil and petroleum product imports, according to official Chinese statistics.

- CNPC announced in its 1998 plan that its production target would be 143 million tons (2.86 million barrels per day (b/d))—as compared with 143.2 million tons in 1997—suggesting that domestic output is likely to remain flat,

Indeed, China's all-out effort since 1997 to secure foreign sources of oil was probably set in motion by the acknowledged failure—after spending billions of dollars in exploration costs—to discover a large oilfield in the Tarim Basin in northern China's Xinjiang Province, according to official Chinese press reports. Since then CNPC has frankly admitted that oil development in the region is unlikely to pan out and has downgraded its importance,

**Seeking Oil Security: Reconciling Policy With Commerce**

Paradoxically, Beijing seeks to guarantee China's energy security by commercializing its oil companies while at the same time requiring an uneconomic foreign investment strategy. The oil security policy reflects concerns with shortages and price volatility of a strategic commodity, which have led in turn to a desire to control sources of crude oil through equity investments in several regions of the world. China apparently seeks to transform its oil companies into global firms—through stronger earnings from oil exploration, development, and distribution—that can compete against the major multinational oil companies; strengthen its diplomatic and trade relations with oil-producing countries; and avoid long-term balance-of-payments problems arising from sharp increases in oil and other raw material imports. [redacted]

China is pursuing a classic energy security strategy—broadly defined as government efforts to seek a long-term relationship with oil-exporting nations—and is attempting to accelerate the development of alternative energy sources. With its focus on cementing access to foreign oil, Beijing's policy probably reflects both a fear of being cut off from foreign oil supplies—possibly by the United States—and a discomfort with market forces:

[redacted]

Beijing plans to develop five bases around the world in regions with large oil resources, according to official Chinese press reports. In October 1997 then-Premier Li Peng identified these bases as the Middle East, Central Asia, Latin America, Russia, and Africa, with a special focus on the Middle East. [redacted] Beijing views developing close ties to the oil-producing, pariah states—where Western corporations are constrained from operating—as both a commercial opportunity and a means of avoiding competition. Li Peng stated that China's strategy for the oil industry is to "cooperate vigorously" with oil-rich countries, particularly the developing countries, to ensure a steady supply of

[redacted]

**Restructuring in the Oil Patch** [redacted]

In March 1998, China's National People's Congress (NPC) approved a reorganization of the bureaucracy and state-owned enterprises, resulting in a shifting of bureaucratic and enterprise responsibilities but changing little in the way business is done:

- The State Development and Planning Commission, which had previously overseen the oil sector, lost much of its power to the State Economic and Trade Commission's Petroleum and Chemical Industry Bureau and to the oil corporations themselves. The bureau has authority for formulating an overall petroleum development strategy, establishing a state petroleum strategic reserve, and regulating the industry, but the corporations have responsibility for setting prices, policy, and investment standards.

- The NPC approved a proposal to merge the assets and responsibilities of the two major corporations—CNPC and SINOPEC—and redistribute them to the two companies along distinct geographic lines; CNPC would be responsible for exploration, development, and trading of oil in the northern and western regions of the country, and SINOPEC would retain those in the eastern and southern. Other oil companies would be placed under the authority of one of the two corporations. [redacted]

The NPC also approved personnel changes at the highest levels of the energy sector, including the oil corporations:

- Former CNPC President Zhou Yongkang is now in charge of the Ministry of Land Resources, which will map out an overall plan for the development of domestic resources, while former SINOPEC President Sheng Huaren has been made chairman of the increasingly powerful State Economic and Trade Commission.

- The new presidents of the two oil corporations have been drawn from the management ranks of the respective companies. [redacted]

[redacted]

petroleum, according to Western press reports; he added that China should use its technology and prospecting abilities to develop these oil resources jointly. [redacted]

Beijing has launched a diplomatic and commercial blitz in the targeted regions:

[redacted]

- Concurrently, Chinese oil corporations are steadily increasing their presence in the base-area countries to secure long-term purchasing arrangements, equity investments in local oil companies, production-sharing agreements, arms-for-oil swaps, and other commercial deals, according to various press reports. [redacted]

[redacted]

**Beijing's Influence Over Commercial Decisions** [redacted]

Beijing's view that it needs to secure a steady supply of oil suggests that it will seek to maintain control over China's oil companies—facilitating the integration of economic and foreign policy with corporate strategy—despite the loosening implied in current market reforms. Beijing continues to set broad goals for the oil corporations; as the legal owner of corporate assets, the central government appoints corporate managers and decides on the scope of domestic operations, as well as mergers and acquisitions. [redacted]

Moreover, the State Council—the government cabinet—and affiliated committees set national energy policy, [redacted] Their directives are implemented by the oil corporations under the direction of the economic commissions: the State Development and Planning Commission (SDPC) and, increasingly, the State Economic and Trade Commission:

[redacted]

[redacted]

**The Economics of Rising Oil Imports** [redacted]

Although Beijing is addressing its oil dependence as a major energy security concern, imported oil plays only a secondary role in China's economy. China relies on coal for over 75 percent of its primary energy needs; oil supplies less than 17 percent, and the Chinese expect it to rise to only 19 percent between 2010 and 2020, according to official Chinese press reports. Moreover, total apparent crude oil consumption last year was 176 million tons (3.52 b/d), of which 33.8 million tons—or the relatively small share of 17 percent—was imported. [redacted]

China is also likely to be able to finance any rise in its oil imports. While the country's much vaunted $145 billion foreign exchange reserves are a symbolic measure of its arsenal of financial resources, its strong export sector and careful management of its balance of payments provide the critical means of financing future oil imports. A strong and growing trade sector also means that oil will be a small share of total imports and easy to service:

- In 1997 China's net oil bill—crude and product—totaled $5.2 billion, about 3.7 percent of total merchandise imports, [redacted]

- In the first 11 months of 1998, China's crude imports slipped to $3.1 billion from $4.7 billion in the same period in 1997. While this number reflects the drop in world oil prices, it also suggests that China's small-scale dependence on oil will not be a problem for some time to come. [redacted]

[redacted]



[redacted]

From a purely commercial perspective, however, China's strategy of seeking foreign oil deals may not be the ideal solution to its oil dependency, for it may do little to insulate the economy from price fluctuations—an important motivating factor in seeking foreign deals, according to official Chinese press reports—and simply add to the country's mountain of bad state-owned enterprise debt. In our view, it would be cheaper for China to buy oil on the spot market than to pay dearly for production-sharing arrangements with other partners, which require substantial outlays for development, transportation, and refining:

[redacted]

**Getting the Oil to Market** [redacted]

The Chinese rely on ships to transport crude and product to coastal cities where demand is highest, but—with growing oil imports—China is considering taking steps to improve its methods of moving foreign oil supplies into and throughout the country. Beijing has indicated it will build a tanker fleet, modernize its port facilities, revamp and expand its refining capacity, build new pipelines, and develop a strategic petroleum reserve, according to Western press sources, but low world oil prices have slowed implementation. [redacted]

[redacted]

***Building a Tanker Fleet.*** SINOPEC is considering building an ocean-going fleet of tankers to carry crude imports, according to Western press sources, but the cost of building or purchasing a fleet of tankers will probably delay implementation of the plan.

***Modernizing Ports.*** China presently has only two ports capable of handling major oil shipments and would need to greatly expand its port facilities to absorb additional foreign oil, which official Chinese press reports show it intends to do.

***Upgrading Refineries.*** Because of the anticipated increase in imports from the Middle East, China has begun to convert some of its refineries to process the high-sulfur crude from that region. The Chinese have plans to build a string of new refineries along the coast by 2010 and, according to Western press reports, SINOPEC signed an agreement with a US company and Saudi Aramco in October 1997 for a feasibility study for a petrochemical complex and expansion of an existing refinery in the southeastern Province of Fujian. Iran has also agreed to participate in a $250 million project to retool China's refineries to handle additional Iranian crude, according to Western press reports.

***Planning for Pipelines.*** Beijing is exploring the feasibility of building pipelines from Kazakhstan that would bring crude oil from these fields directly into China. Indeed, promises of pipeline construction have been instrumental in China's securing of oil deals with Kazakhstan, but the high costs are proving to be a major impediment, according to press reports

***Developing a Petroleum Reserve.*** SINOPEC is also drawing up plans to build a strategic petroleum reserve to use as a buffer against sharp increases in world oil prices, according to Western press reports. Planners are particularly concerned that political disturbances in the Middle East—the source of most of China's imported oil—could cause supply disruptions, such as those that occurred twice in the 1970s, . Nonetheless, China's lack of salt domes along the coast makes the creation of a petroleum reserve questionable, and the storage costs may in the end scuttle the plan.

**Implications for the United States**

Beijing's apparent perception of its growing dependency on foreign oil imports as a security concern and official Chinese press reports of Chinese oil company executives projecting that they will be seeking oil deals overseas over the next five years lead us to conclude that the Chinese will continue to seek an increasingly prominent role in the

**Slow Pipelines to China** [redacted]

All of the proposed oil and gas pipelines from Russia or Central Asia to China are in preliminary planning stages, and none—even the frontrunning Kazakhstan-China and Russia-China pipelines—are likely to be onstream before 2005. [redacted]

***Kazakhstan-China Oil Pipeline.*** The China National Petroleum Corporation (CNPC) reportedly promised in mid-1997 to build a pipeline that would carry 400,000 to 500,000 barrels per day from western Kazakhstan to the Karamay oilfield in Xinjiang Province. The pipeline was an important part of the company's successful competition against major Western oil firms for rights to redevelop the Aktyubinsk and Uzen fields, according to numerous press reports [redacted] but it may not meet the target completion date of 2005 announced by Kazakhstani officials. [redacted]

Press reports say the pipeline will cost $2.5 to $3.5 billion, but there is little information on how the estimates were calculated. Other press reports [redacted] indicate that the pipeline—with a capacity of about double the total announced target output from CNPC's fields in Kazakhstan—may be uneconomic by Western industry standards and therefore difficult to finance. Evidence of preparation for substantial work on a large-diameter, cross-China pipeline indicates that some planning is under way for shipping large volumes of oil from Xinjiang, which is self-sufficient in oil, to consumption centers in central and eastern China. The results of a feasibility study—expected in early 1999, according to a survey of press [redacted] reports—will probably help firm the construction schedule. [redacted]

***Russia-China Gas Pipeline.*** Russia and China first signed a memorandum of understanding (MOU) in June 1997 for a 4,000-km pipeline from the Kovyktinskoye field in eastern Siberia to China and possibly continuing on to Japan and South Korea, according to industry press reports. MOUs occur at early stages of project discussions, however, and Western observers question the feasibility of the $10 billion project. Gazprom chairman Vyakhirev asserts that the field lacks sufficient reserves to support the project, according to press reports. Other press reports note that representatives from Russia (Sidanko), China (CNPC), UK (British Petroleum), Japan, South Korea, and Mongolia have agreed to carry out an assessment of the field's reserves. [redacted]

[redacted]

international oil market. Over the short term, this effort could pose challenges to the United States, both in terms of commercial trade and diplomatic initiatives:

- *Increased competition for US firms.* CNPC has already edged out US oil companies in Venezuela and Kazakhstan through higher bids and questionable promises of follow-on arrangements, such as pipeline construction, according to press [redacted] reports. Complementary diplomatic and economic initiatives—including direct intervention by the senior leadership in some deals and additional non-oil-related trade and investment offers—to oil-producing countries are better positioning Chinese oil firms for preferential treatment.

- *Competition for regional influence.* As concern with oil security has spurred Beijing to diplomatic and economic initiatives to improve ties to the Middle East, Central Asia, and Africa, [redacted] the Chinese have explicitly sought to counter US influence. Such efforts could increasingly interfere with US policy goals, particularly in the Middle East. For example, while Chinese oil firms have not violated UN sanctions against Iraq, their successful bids for exploration and eventual development of Iraqi oilfields show that they are positioning themselves for an end to the embargo; [redacted] Chinese diplomats have suggested time limits and a gradual lifting of sanctions against Baghdad. More generally, Chinese academics and MFA officials have called for China to play a more active role in Middle Eastern politics, [redacted]

Over the longer term, Chinese initiatives to secure foreign oil resources could become a source of tension in bilateral relations:

- *Temptation to proliferate.* Should China face balance-of-payments problems that result in a sharp decline in its foreign exchange reserves, Beijing may seek to import more oil on a barter basis and broaden its oil-for-arms arrangements, [redacted] Beijing has been pushing for removal of UN sanctions on Iraq, with which it has signed contracts for oilfield development in the past year, and has expressed concern about continued sanctions on Libya. Oversight authorities may even turn a blind eye to Chinese firms that seek to circumvent restrictions on trade with these countries; [redacted]

[redacted]

- *Exports to subsidize oil investments.* Beijing may view its investments in foreign oilfield development as a long-term cost that needs to be financed through rising exports, an action that would fuel friction in US-Chinese trade relations. China's oil companies in the transition from domestic producers to global firms—lacking independent sources of foreign exchange—appear to have drawn on government resources for their overseas operations, but Beijing now expects the companies to raise funds in the capital markets.